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IN THE

Supreme Court of the United States

October Term, 1982

PAUL P. and LYNN T. BROUNTAS,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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QUESTION PRESENTED FOR REVIEW

Whether the court below correctly construed Section 636 of the Internal Revenue Code of 1954, as amended, 26 U. S. C. § 636, in holding that an oil or gas production payment (which Congress, in response to tax avoidance allowed by the previous tax law under the ABC transaction, has mandated be treated as a mortgage loan) does not provide basis, and is not accruable, because the uncertainties of hydrocarbon production make the production payment contingent, even though the Treasury Regulations promulgated at the direction of Congress which define a production payment specifically recognize the necessarily contingent nature of a production payment—"if, as and when produced"—and, notwithstanding the contingency, prescribe loan treatment for the production payment for both deduction and income attribution purposes.

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PETITION FOR WRIT OF CERTIORARI

Petitioners Paui P. and Lynn T. Brountas respectfully pray that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the First Circuit entered in this proceeding on September 28, 1982.[1]

OPINIONS BELOW

The Opinion of the United States Court of Appeals for the First Circuit filed on September 28, 1982 was published at 692 F. 2d 152 (1982) and is set forth on pages A1 through A24 of the separate Appendix filed herewith pursuant to Rule 21.1(k). The Order of the United States Court of Appeals denying Petitioners' Application for Rehearing or Rehearing En Banc is unpublished but is set forth on pages A25 through A26 of the separate Appendix hereto. The Opinions of the United States Tax Court which underlie this proceeding are published at 73 T. C. 491 (1979) and 74 T. C. 1062 (1980) and are set forth at pages A35 through A195 of the separate Appendix hereto.

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1. The parties to this proceeding in the court below were Paul P. and Lynn T. Brountas and the Commissioner of Internal Revenue.

STATEMENT OF JURISDICTION

The judgment of the United States Court of Appeals for the First Circuit sought to be reviewed was dated and entered on September 28, 1982. The Order denying Petitioners' Petition for Rehearing was entered on November 17, 1982. On February 7, 1983 this Court, per Mr. Justice Brennan, entered its Order extending the time to and including March 10, 1983, within which Petitioners might file a Petition for Writ of Certiorari. This Court has jurisdiction to review the final judgment of the Court of Appeals pursuant to 28 U. S. C. § 1254(a)(1).

STATUTORY PROVISION INVOLVED

The Internal Revenue Code of 1954, as amended, 26 U. S. C. § 636, provides:

> "§ 636. Income Tax treatment of mineral production payments.
>
> "(a) Carved out production payment.—A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property. In the case of a production payment carved out for exploration or development of a mineral property, the preceding sentence shall apply only if and to the extent gross income from the property (for purposes of section 613) would be realized, in the absence of the application of such sentence, by the person creating the production payment.

"(b) Retained production payment on sale of mineral property.—A production payment retained on the sale of a mineral property shall be treated, for purposes of this subtitle, as if it were a purchase money mortgage loan and shall not qualify as an economic interest in the mineral property.

"(c) Retained production payment on lease of mineral property.—A production payment retained in a mineral property by the lessor in a leasing transaction shall be treated, for purposes of this subtitle, insofar as the lessee (or his successors in interest) is concerned, as if it were a bonus granted by the lessee to the lessor payable in installments. The treatment of the production payment in the hands of the lessor shall be determined without regard to the provisions of this subsection.

"(d) Definition.—As used in this section, the term 'mineral property' has the meaning assigned to the term 'property' in section 614(a).

"(e) Regulations.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section.

"Added Pub. L. 91-172, Title V, § 503(a), Dec. 30, 1969, 83 Stat. 630, and amended Pub. L. 94-455, Title XIX, § 2906(b)(13)(A), Oct. 4, 1976, 90 Stat. 1834."

STATEMENT OF THE CASE

On July 14, 1976, the Commissioner of Internal Revenue issued a Notice of Deficiency for the 1972 tax (and calendar) year of Petitioners Paul P. and Lynn T. Brountas, which Notice placed in issue the tax treatment accorded their limited partnership investment in exploratory and developmental oil and gas drilling, especially as that tax treatment related to deduction of intangible developmental and drilling costs (26 U. S. C. § 263) arising out of payment made via nonrecourse notes/production payments (26 U. S. C. § 636). A timely Petition was filed with the Tax Court. Upon completion of the pleadings and discovery phases of the case, and following a series of pretrial Orders, the case came on for trial before Judge Cynthia Holcomb Hall [2] from January 8 through 18, 1979 and from February 6 through 9, 1979. At the close of these 13 days of bench trial, having heard 41 witnesses and having accepted, pursuant to Rule 804(b)(5) of the Federal Rules of Evidence, four volumes of sworn testimony of a deceased witness, along with hundreds of exhibits and several stipulations, the Tax Court filed two separate opinions on December 26, 1979 (A35) [3] and August 13, 1980 (A177).[4]

The Tax Court's decision pursuant to Rule 155 of the Rules of Practice and Procedure of the United States Tax Court was ultimately entered on August 26, 1981. The Commissioner's Notice of Appeal to the First Circuit was timely filed on November 23, 1981.

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2. The Tax Court Judge who heard and decided this case, Cynthia Holcomb Hall, now sits on the United States District Court for the Central District of California having been appointed to that Bench by President Reagan on November 20, 1981.

3. 73 T. C. 491 (1979).

4. 74 T. C. 1062 (1980).

The issues in the decision of the Tax Court from which the Commissioner took his appeal arose from the December 26, 1979 opinion and involve the application of a special provision of the Internal Revenue Code (§ 636) to facts found by the Tax Court after the 13-day bench trial. The narrow scope and predominantly factual nature of the Tax Court rulings here in issue has been made plain by subsequent decisions of that court: *e.g.*, *Burns v. Commissioner*, ¶ 78.14 P-H TC (1982) and *Brannen v. Commissioner*, ¶ 78.33 P-H TC (1982); compare, *Smith v. Commissioner*, ¶ 78.26 P-H TC (1982) and *Grodt and McKay Realty, Inc. v. Commissioner*, ¶ 77.89 P-H TC (1981); Hall, J.

The Tax Court below rendered its ultimate findings of fact, as follows (A92-93):

> "The nonrecourse Notes which were included in these transactions had value and commercial reality and were not shams.
>
> "Transactions between CRC (on behalf of itself and the other investors) and the various operators followed a general pattern. In each case the operator would submit to CRC a package of geological prospects to be drilled, along with the lease purchase cost and the drilling contract cost for the proposed package. The operators were aware they would receive cash and a nonrecourse Note; the cash/note ratio was usually 40/60. The operators were also aware that they would receive a completion option, which would entitle them to a share of production if they paid the costs of completing the well and reimbursed certain costs to the Investors.
>
> "CRC and the operators engaged in arm's-length negotiations as to the lease purchase and drilling prices. *The drilling contract terms agreed to were*

always fair and reasonable in light of the contingent nature of part of the price and the risks undertaken by the operator in a no-out turnkey drilling contract. *The lease purchase terms were also fair and reasonable* again considering the contingent nature of part of the price. Moreover, *the total consideration which the Investors gave to the operators—cash, the Note and the completion option—was fair and reasonable compensation for the leases and the services performed and contributions made by the operators.* The transactions were integrated wholes, and the Notes were an integral part of these transactions.

"The Notes were nonrecourse and were secured, in economic reality, only by the oil and gas found. The Notes were cross-collateralized, so that production from any one prospect within a package secured the entire Note. Although the Notes were also secured by the equipment on the leasehold and the mineral interests, if all the test wells in a package produced dry holes, this security had de minimis value. If all the wells in a package were plugged and abandoned, the nonrecourse Notes became worthless. The operators viewed the Notes as substantially equivalent to production payments, which are a right to a specified amount of money only out of a specified portion of the production of one or more wells." (Emphasis added.)

So far as is germane to this Petition, the following summarizes the vital factual and legal determinations made by the Tax Court, all of which are amply supported by the record:

(1) The nonrecourse notes constituted production payments, or the substantial economic equivalent

thereof, within the meaning of § 636 and the Regulations thereunder;

(2) Since the collateral (if any) securing payment of the nonrecourse notes, other than mineral production rights, was not economically significant, under the Congressionally mandated Treasury Regulations (Section 1.636-3(a)(2)) and under applicable case law, *e.g., Standard Oil Co. (Indiana) v. C. I. R.*, 465 F. 2d 246 (7 Cir. 1972), the production payments (or their economic equivalent) did not lose their status as such; and

(3) As a consequence of § 636, and the Congressionally mandated Regulations, read in light of the statute's legislative history and Congressional purpose, the notes/production payments create basis in their face amount thereby permitting deduction of the intangible drilling costs paid in that amount by that means.

On September 28, 1982, the United States Court of Appeals for the First Circuit, after first noting that "the propriety of the deductions is a complicated and unsettled question" (A2), consistently with the Tax Court,[5] found it to be "highly doubtful that the nonrecourse notes . . . or any similar nonrecourse highly contingent obligation would be a liability for purposes of § 752(a) [governing basis in a partnership], (A9) "[w]ere it not for the special "production payment" section of the Code, § 636 . . ." (A9). Then, having found that it was not "required" to follow the Tax Court's analysis of § 636 (A17); that its own interpretation of the statute "would not, as far as we know, interfere with any of § 636's stated purposes" (A17); that "the language of § 636 is broad enough to

5. 73 T. C. 559.

allow this result" (A17); and that "Treasury Regulations offer mild support for our interpretation of § 636" (A18), the court below concluded that the Tax Court's reading of § 636 produced an "absurd result" (A18).

Thus, while paying no attention to the precise definitional language of the applicable Treasury Regulation (§ 1.636-3(a)(1)), the court below contended (A19):

> "Finally, the single argument that gives us pause consists of the claim that where production payments are at issue, highly contingent or speculative repayment obligations should not be distinguished from others because production payments are *always* speculative. One can never be certain whether there is sufficient oil to meet the payment. We do not consider this argument determinative, however, because one can still distinguish among degrees of uncertainty; a right to collect funds from a property where oil has not yet been found would seem far more speculative than rights secured by the production of existing wells. . . ."

Hence, the court below entered its judgment vacating the decision of the Tax Court, rejected the applicability of § 636 and remanded the cause to the Tax Court (A24), all in disregard of the Treasury Regulation, the legislative history of § 636 and its Regulations, and the understanding of the statute held by the industry, the bar and the commentators.[6]

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6. *See, e.g.*, Fielder, *Drilling Funds and Nonrecourse Loans—Some Tax Questions*, 24 Inst. on Oil & Gas L. and Tax. 527 (1973), at pp. 546-547:

> ". . . Section 636, added by the Tax Reform Act of 1969, and the Proposed Regulations promulgated thereunder, clearly seem to classify such a transaction as a mortgage loan with all of the tax consequences of a true loan following in suc-

The facts as found by the Tax Court may be summarized as follows :

Paul P. Brountas is a Boston lawyer (a Hale and Dorr partner) who resides in Weston, Massachusetts. In 1972, Mr. Brountas became a limited partner in Special Coral 1972 Drilling Venture I ("Coral I" hereafter) and contributed $10,000 to that partnership to acquire his partnership interest. He had an 0.8811% capital and profits interest and contributed an additional $1,000 in cash in 1973 as part of the partnership's program to develop the oil and gas fields which it had discovered in its exploratory phase.

Coral I is a limited partnership duly organized under the laws of the State of Texas, formed and operated for the purpose of participating in the acquisition, exploration and development of oil and gas properties. The partnership used the accrual method of accounting and validly elected, pursuant to IRC § 263, to deduct intangible development and drilling costs. The general partner of the partnership is CRC Corporation, a Delaware corporation having its principal office in Jenkintown, Pennsylvania. In 1972, CRC Corporation contributed $25,000 in cash to the Coral I venture in exchange for a 2.2026% capital and profits interest. CRC also made investments in other oil and gas partnerships formed in 1972, as well as making direct investments in oil and gas properties. CRC, as general partner—like Brountas as a limited partner—

6. (Cont'd.)

cession. The effect is ironic. A nonrecourse loan which is not to be treated as a true loan on the basis of an examination of all its facts and circumstances is then, by statute, reclassified into the equivalent of a true loan. Perhaps, one may conclude to his mild amusement that the Treasury, as it has before, won too much when it persuaded Congress to enact Section 636 and must now suffer to be hoist on its own petard."

made an additional cash contribution in 1973 to aid in the development of producing properties.

The oil and gas ventures involving Brountas, CRC and Coral I, were "leveraged"[7] in that nonrecourse notes were used as a portion of the consideration (in addition to cash contributed by the partners and in addition to property rights and interests in the partnership properties conveyed by the partnership) in transactions with unrelated oil and gas operators. As a result, the partnership and, hence, the general and limited partners claimed deductions for federal income tax purposes in the amount of $1.89 for every $1.00 cash investment. The Tax Court decision allows deductions of about $1.40 for every $1.00 cash invested.

CRC introduced two core concepts of investor protection to the limited partnership format: (1) a no-out turnkey drilling contract and (2) production payment financing to provide the leveraging. The no-out turnkey drilling concept is represented by a contract under which the operator guarantees that, for a fixed price, all wells contracted for with the partnership will be drilled at no further cost to the investor regardless of difficulties encountered. That is, all the financial risks of drilling—beyond initial cash received from the investor—are placed on the operator.[8]

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7. In tax parlance, "leveraged" means an investment yielding deductions which in the aggregate exceed the taxpayer's initial cash investment for the purchase price—such as an investment in commercial real estate—but with a parallel obligation to pay taxes on income in excess of cash receipts: the "*Crane* symmetry". Compare *Commissioner v. Tufts*, No. 81-1536 before this Court.

8. An example of the value to the investor—and risk to the operator—of this no-out turnkey as found by the Tax Court was the Boyken Church Prospect: "The possible adverse effects of the no-out turnkey drilling obligation on an operator was illustrated

As to the production payment concept—the concept at the heart of the instant litigation—CRC conceived, and enforced in its negotiations with the operators, the proposition that a portion of the sum agreed to be paid for the no-out turnkey drilling contract (and for the mineral lease) was paid via a nonrecourse note. In addition to the obvious tax benefit to the partners, this leveraging limited the amount of cash the investors had at risk and was perceived by the operators as serving the function of a "production payment", *i.e.*, an element of potential profit dependent upon successful exploration which helped compensate for the risk inherent in the "no-out" contracts. Several of the operators (including the Commissioner's own witness) and a Texas state law expert all testified, without contradiction, that the property interest arising out of the nonrecourse note is a production payment. In connection with the motivations of the taxpayers, Paul P. Brountas was found by the Tax Court to have "invested $11,000 in the Coral I limited partnership with the purpose of profiting from the investment."

In 1972, on behalf of Coral I and its partners, CRC entered into various agreements with various operators. These agreements, which consisted of (1) a Lease Purchase and Turnkey Drilling Agreement; (2) a Loan Agreement; (3) a Promissory Note; (4) a Mortgage, Deed of Trust, Assignment of Security Interest; and (5) a Joint

8. (Cont'd.)

by the Boyken Church Prospect which Patrick Petroleum Co. drilled for CRC. Patrick Petroleum had estimated the cost of this well to be $375,000, but its actual out-of-pocket cost was $975,000 because the well had to be drilled three times. The first time the well was drilled, there was a blowout when a high pressure reservoir was encountered. The second time the well was drilled, the drilling pipe separated and a portion was lost. On the third attempt, the well was successfully drilled, but it was a dry hole."

Venture Agreement, pertained to a "package" of prospects submitted by an operator.[9] The court below found as a fact that these five contracts were inseparable as interlocking parts of an integrated transaction.

Coral I was represented in its negotiations with the operators by a partnership-employed geologist (Mr. Floyd) who was a competent and "tough negotiator"; who attempted to obtain the lowest possible price for the lease and drilling contracts in order to benefit the investors; who negotiated the lease purchase prices and the drilling contract prices separately; whose negotiations concerned only the total price without regard to the note portion versus the cash portion; and whose negotiations with the operators were at arm's length. The Tax Court found that, as consideration for sale of the mineral lease to the partnership and as consideration for the undertaking of a no-out turnkey obligation, the partnership transferred to the operators cash plus a nonrecourse note plus a completion option so that the operator received cash and a retained or carved-out production payment.

In each case, the Tax Court found the terms of the agreements between the operators and the partnerships to be within a reasonable range of commercial practice. For example, if the drilling contract price were $100,000, of which the cash portion was $40,000 and the note portion was $60,000, the $40,000 plus the nonrecourse note and completion option was fair and reasonable consideration for the no-out turnkey drilling contract involved. Similarly, the lease purchase terms were also fair and reasonable and the terms of the total contract were found

9. A package involved two or more (typically three) noncontiguous oil and gas prospects to be drilled by a single operator. Participation in the various packages was shared by various limited partnerships and a limited partnership invested in many packages, receiving a percentage interest in each, in order to obtain diversification.

by the Tax Court to be fair and reasonable. Moreover, at least two of the operators did not consider the transaction acceptable if they received only the cash portion plus the completion rights, but not the note.[10]

In order to verify that the drilling contract prices were fair and reasonable CRC instituted—on behalf of the partnerships—a "double check" on their chief geological executive. That is, Floyd was instructed to obtain from independent petroleum engineers opinions as to whether the drilling contract price for a proposed no-out turnkey drilling contract was fair and reasonable: [11] after CRC and an operator agreed upon a price for the contract, an independent engineer would be asked to opine whether the agreed-upon price was a fair and reasonable one. These engineers did not know that the drilling contract price would not be paid wholly in cash nor did they know about the completion option. They did, however, know of the "no-out" feature. Nine such independent petroleum engineers testified in this case. All of these engineers expressed the opinion that the total no-out turnkey drilling contract prices were fair and reasonable in light of the no-out drilling obligation assumed by the operators.

Fifteen of the 41 witnesses who appeared before the Tax Court were operators who testified regarding the basic economic substance of the overall transaction and

10. *E.g.*, the operator would have received $40,000 in cash plus the completion rights, but not the $60,000 note. Only two operators (one of whom was a witness called by the Commissioner) directly addressed this question. Another operator believed that the notes were important, but he did not specifically consider whether he would have entered into a transaction without the note. A fourth operator, called as a witness by the Commissioner, also stated that the notes were of value to him and that he wanted the notes as part of the transaction.

11. These opinions also served as verification to CRC's auditors that the prices paid were fair and reasonable.

as to their negotiations with Mr. Floyd. They testified as to the risks they assumed and—in several instances—the money they lost because of the no-out turnkey agreement. The operators also testified as to the entire bundle of rights received by them in exchange for the bundle of obligations they gave to the partnerships and of their unwillingness to separate any one part of the consideration out of the entire transaction. Thus, the Tax Court found that the nonrecourse notes which the Investors gave to the operators had economic significance and were a *bona fide* bargained for part of these transactions. These transactions were interrelated and integrated wholes.

The Commissioner's own key witness below, a former chief geological executive of CRC, testified, consistently with the testimony of other operator witnesses, that there was not sufficient profit for an operator to justify the transaction without the production payment.[12] In addition, the operators testified that the payments due under the Loan Agreement and the nonrecourse note were considered by them to be a production payment.

A production payment in the strict sense is defined in § 1.636-3(a)(1) of the Income Tax Regulations:

> "(1) The term 'production payment' means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. . . ."

But for tax purposes, the Treasury has, pursuant to the direction of Congress, defined the term more broadly in Reg. 1.636-3(a)(2); *i.e.*, "a right which is in substance *economically* equivalent to a production payment . . ."

12. In commenting that the Commissioner's key witness was not candid or credible, the Tax Court notes, in footnote 56:

> ". . . in prior testimony, Scoggins stated that as an operator "[H]e would never have made the trade without the loan. * * * There wasn't enough profit in it without the loan!"

In any event, both the operators who testified and the state law expert on Texas real property interests (Mr. Henderson) and the federal tax expert (Professor Eustice, Associate Dean of the NYU Law School Graduate Tax Program)[13] who testified in the court below, described the interests and the statute here involved in ways which amply support Judge Hall's ultimate finding of fact; namely, ". . . whether or not the interests in question were production payments, they do not fall outside § 636 . . . They are either production payments or they are the economic equivalent."

The operators drilled and tested all 100 wells as required under the Lease Purchase and Turnkey Drilling Agreements entered into in 1972. All the operators hoped to cover their drilling costs, including overhead, with the cash portion of the drilling contract prices received from the investors; some were successful in satisfying their drilling obligations for only the cash received; others were not.[14]

Sizable reserves of oil and gas were found. The total partnership investments in the 1972 program were $35,000,000 in cash and $52,000,000 in nonrecourse Notes. As of July 1, 1976, proven reserves in the ground from the 1972 program (determined by an independent engi-

13. Professor Eustice was permitted to testify because the Commissioner sought to charge the general partner with a civil fraud penalty under § 6653(b). This penalty was rejected by the court below but its assertion made it possible for the court to entertain testimony bearing on CRC's state of mind: opinion evidence of nationally respected tax experts that the tax treatment of the nonrecourse notes on the partnership returns was rational, *bona fide* and justifiable on the basis of the specific language of § 636 and the Treasury Regulations thereunder.

14. As the Tax Court found, there was very little investor money available for oil and gas drilling in 1972. Accordingly, the partnerships were in a strong bargaining position.

neering firm) had a value in excess of $68,000,000 which, after deductions for costs meant payables to the partnerships in excess of $40,000,000.[15] This amount is in addition to all oil and gas extracted before July 1, 1976.

15. As a result of international developments and inflation these reserves have, of course, increased in value and partners such as Brountas and CRC have been receiving significantly greater cash returns on their investments.

REASONS FOR GRANTING THE WRIT

The decision of the court below, rejecting the Tax Court's studied analysis of § 636 of the Internal Revenue Code and denying deductions to these petitioning taxpayers, contradicts and nullifies the purpose of Congress in enacting § 636, ignores the Executive Branch interpretation and intentions as to § 636 as reflected in official Treasury Regulations, and permits the recrudescence of a tax gimmick—the ABC transaction—which, Congress and the Treasury thought, was laid to rest by the enactment of § 636.

I. § 636 and Basis/Deductibility

In the face of the foregoing facts of record, the Commissioner now concedes that—and the court below agrees that—the nonrecourse notes do constitute production payments or the substantial economic equivalent thereof within the meaning of § 636 of the Internal Revenue Code. The only remaining question is whether that conclusion as to statutory coverage permits the tax treatment—the deductions—here claimed.

The First Circuit's decision in *Brountas* does, contrary to that court's off-hand impression (A17), interfere with the purposes of § 636. That is, when this Court classified production payments as an "economic interest in mineral in place", with concomitant shifting of income attribution, it did so precisely because the production payment was contingent; *i.e.*, a production payment represented an investment in oil and gas in place and ". . . the possibility of profit . . . was contingent solely upon the extraction and sale of the oil". *Commissioner v. Southwestern Exploration Inc.*, 350 U. S. 308 (1956). Hence, Congress, at the urging of the Treasury, and in order to correct the abuses of that income attribution which results from the

ABC transaction, modified this line of reasoning by the enactment of § 636 and sought thereby to change the tax treatment of production payments, both as to income attribution and as to basis for deductions. Indeed, those two attributes—income attribution and basis for deduction—cannot be severed as is artificially done by the court below.

The legislative history of § 636 (including, principally, the testimony presented to Congressional Committees) shows that the case for enactment of § 636 was predicated upon the fact that many production payments were based upon verified hydrocarbon reserves and well production histories such as to reduce the level of risk to that of a well secured bank loan. Accordingly, this rationale for adoption of § 636 left open the question whether § 636 was to be inapplicable in the case of a production payment unsupported by verified reserves or producing history—a "highly speculative" production payment—and, therefore, whether such a production payment would still be regarded as an economic interest in mineral in place, thereby making use of the ABC transaction a continuing possibility.[16]

Hence, Exhibit 167 was admitted into evidence below to establish, as Judge Hall found, that, save for the exploration/development carveout (an exception not applicable to this case), no contingency exception to the production payment doctrine would be tolerable to the Congress or to the Treasury. As shown by that Exhibit, two successive Commissioners of the Internal Revenue

16. Congress had, of course, excluded from § 636 one form of speculative production payment, the payment carved out for exploration or development (see 26 U. S. C. § 636(a)). As Judge Hall noted for the court below, the production payments here in issue were factually not such carve-outs. Neither did the Commissioner so contend. See, also, Berry, *Section 636—Production Payments*, 25 Oil & Gas L. & Tax Inst. 389 (1974).

submitted draft Regulations (as mandated by Congress under § 636(e)) to the Secretary of the Treasury setting forth a clear understanding that ". . . a contingent production payment . . ." is to be treated no differently than any other production payment for § 636 purposes.

The transmittals from the IRS to the Treasury show conclusively that the Regulations are specifically intended to delete contingency as a criterion for debt treatment of a production payment. In his February 23, 1971 cover letter transmitting the proposed 636 Regulations for publication in the Federal Register, Commissioner Randolph W. Thrower specifically stated to Assistant Secretary of the Treasury Edwin S. Cohen (Exhibit 167 at 2):

> "The proposed regulations deviate from general mortgage loan treatment in that they do not provide an exception, in the case of a contingent production payment, to the requirement that the principal balance of a production payment be included in determining the amount realized on a sale or other disposition of the burdened mineral property. See § 1.636-1(c)(1). . . ."

In the same letter, Commissioner Thrower explains that this (and other) deviations of the § 636 Regulations from "general mortgage loan treatment" are "considered necessary in order to prevent abuse of Section 636. Congress expressly authorized the issuance of regulations to prevent such abuses."

This decision to exclude the contingency principle from § 636 was taken in full light of the common knowledge that contingency was inherent in a production payment:

> ". . . As a practical matter, you know, if you don't get paid out of an oil and gas property, you

end up with nothing either way—" (Testimony of operator Lawson before the Tax Court in this case.)

* * *

"Q. What effect, if any, in your opinion, did Section 636 have on the contingency problem which arose in the question of debtor-creditor relations under the Federal Income Tax laws?

"A. Well, if you take a production payment which is the subject matter of Section 636, by the very definition of a production payment it is almost perforce contingent, it has a cap on it, but it has absolutely no floor and [is] somewhat in the nature of preferred stock, really. You can lose everything and there is absolutely no other than professional expertise [sic], that it will pay out, but it will only pay out to a ceiling amount. *In other words, it's inherently contingent.*

"Q. *And, ergo, the contingency problem did what?*

"A. Well, *if you found yourself within 636, it wasn't there. In fact, the statute treated it as an immediate debt and the regs are quite clear on that.*" (Testimony of Professor Eustice before the Tax Court in this case.)

This studied determination not to permit a contingency exception to the treatment of a production payment for tax purposes as a loan, reenforced by the official administrative opinions of two separate Commissioners of Internal Revenue, has been nullified by the First Circuit's *Brountas* Opinion.

By denying production payment treatment to the notes in this case (and, inferentially, to any production payment which a fact finder concludes to be "highly

speculative" or "contingent"), the First Circuit has resurrected the status of "economic interest in the mineral in place" for such a production payment, thereby permitting re-creation of the ABC transaction thought laid to rest by the adoption of § 636. Irrespective of jurisprudential legerdemain, a production payment cannot—*pace* First Circuit—be a loan for income attribution purposes but not be a loan for basis/deductibility purposes.

The logic of Judge Hall's Opinion for the Tax Court below (which, incidentally, was reviewed by the Chief Justice of that Court before release as is required in that Court and was thereafter denied both reconsideration and full court review by the Tax Court, notwithstanding motions so requesting by the Commissioner) may be succinctly summarized as follows:

A. Sections 636(a) and (b) of the Internal Revenue Code and the Regulations thereunder all expressly provide that ". . . *for purposes of this subtitle* [the Federal Income Tax] . . .", a production payment shall be treated as a mortgage loan. For example, Regulations § 1.636-1(a)(1)(i) is plain:

> "*For purposes of subtitle A of the Internal Revenue Code of 1954*, a production payment (as defined in paragraph (a) of § 1.636-3) to which this section applies shall be treated as a loan on the mineral property (or properties) burdened thereby and not as an economic interest in mineral in place . . ." (Emphasis supplied.)

That is, § 636 is one of the rare instances in which one section of the Internal Revenue Code has been specifically declared by Congress to override all others and to preclude the application of generalized tax principles. Thus, § 636 controls over all other provisions, including basis, accrual, contingency, *etc.* And, notwithstanding the First Circuit,

the explicit language "for purposes of this subtitle [the Federal Income Tax]" permits no construction which says that "for some purposes of this subtitle, but not for other purposes."

B. A production payment is—by definition and of necessity—contingent. Treasury Regulation § 1.636-3 (a)(1) begins the definition as follows:

> "The term 'production payment' means, in general, a right to a specific share of the production from mineral in place, (*IF*, as, and when produced), or the proceeds from such production. . . ." (Emphasis supplied.)

This definition was specifically created and adopted by the Treasury as being the definition ". . . understood traditionally with respect to production payments which constitute economic interests in mineral in place. . . ." And especially note the preposition set forth in the definition "*if* . . . produced". Simply put, anyone with the least knowledge of the oil and gas industry knows that any production payment is contingent since any production in any well, even the most proven with the best history, can stop at any moment.

C. Further, without regard to the definition of production payment, the fact of contingency does not deprive a production payment of its favored tax treatment. See, again, Exhibit 167.

D. An "oil country court"—in a decision not appealed by the Commissioner—has ruled, contrary to the First Circuit, that § 636 treatment does apply to interests identical with those here in issue. *Dillingham v. United States*, 48 A. F. T. C. 2d 81-5815 (D. Okla. 1981).

E. All the witnesses who appeared before the court below, including the Commissioner's own, recognized

these property rights for what they are, *i.e.*, production payments or the economic equivalent thereof.

F. Judge Hall has found as a fact, applying the tests of Treasury Regulation § 1.636-3(a)(2)—"[w]hether or not a right is in substance economically equivalent to a production payment shall be determined from all the facts and circumstances"—that the property rights represented by the notes in question are the substantial economic equivalent of production payments, a finding of fact not challenged by the Commissioner or by the First Circuit Court of Appeals panel.

G. In causing Congress to adopt § 636, the Treasury and the Internal Revenue Service got precisely what it bargained for. That is, as Professor Fielder noted ". . . the Treasury, as it has before, won too much when it persuaded Congress to enact Section 636 and must now suffer to be hoist on its own petard." (For the full quotation see fn. 6, *supra.*) Or, as Judge Hall (now of the United States District Court for the Central District of California said in responding to the undersigned after she had received a copy of the First Circuit's Opinion:

> "Thank you for sending me the First Circuit's opinion in *Brountas.* I see they let Congress off the hook under Section 636. It seems to me when Congress overreacts to one problem so as to create another they should be held to the language of the law."

H. The income attribution consequences of § 636 cannot be severed from the basis/deductibility consequences of § 636 in the absence of Congressional permission to do so, evidenced in the language of the statute. Nor can one ". . . distinguish among degrees of uncertainty . . ." (A19) with respect to production payments in the face of the statutory language, in the face of the

Regulation language, and in the face of the express definitional language based upon history and industry and Treasury understanding.[17]

In sum, the court below errs by failing to take into account the express language of the statute and the express language of the Treasury Regulations, as well as in permitting the resurrection of the ABC transaction.[18]

II. Accruability

On the one hand, The First Circuit ruling on accruability is dictum since the Court's decision on § 636 and basis was sufficient to decide the case. And, of course,

17. The notion of distinguishing "among degress of uncertainty" is, of course, an invitation to litigation and itself contributes to an unnecessary (and undesirable) lack of certainty in many business transactions. After all, how "uncertain" is "uncertain"?

18. Further anomaly flows from the Commissioner's position which has been sustained by the First Circuit. That is, while the Commissioner vehemently urges this Court to accept the Third Circuit's jurisprudence in *Millar v. Commissioner*, 577 F. 2d 212 (1978), the Commissioner by his argument here and in the First Circuit has accepted *Millar* only in so far as it lays down a rule of income recognition and taxability for cancellation of indebtedness. (A rule with which Petitioners, of course, concur, having paid taxes on the cancellation of indebtedness income even before the Third Circuit decided *Millar*.) But, in relying upon *Millar* in his *Tufts* argument before this Court (No. 81-1536, argued on November 29, 1982), the Commissioner overlooks the circumstances of the *Millar* transaction as found by the Tax Court; *i.e.*, the fact that the mineral property there involved—coal lands—was determined by the taxpayers' own engineer to have been highly speculative. And, of course, in terms of debt repayment's being "highly speculative" and "contingent", it is difficult to find a property more fitting of that description than the real estate acquired by Mrs. Crane (and on which she made no debt service payments during her ownership) which led, in turn, to this Court's decision in *Crane v. Commissioner*, 331 U. S. 1 (1947).

the Commissioner raised no argument as to accruability in the Tax Court with respect to § 636.[19]

More importantly, however, the First Circuit opinion on accurability confuses the difference between a contingent obligation (which cannot be accrued for the reason that the all events test has not been met) and the situation in which an accrual basis taxpayer and his creditor agree that a present property interest of future or contingent value will be accepted in satisfaction of a vested dollar obligation. In this latter case, the taxpayer may accrue the obligation because the all events test has been met in that the obligation to pay a vested dollar amount has been *satisfied* by delivery of the property of contingent value thereby eliminating any possibility of non-payment. *Cf. Commissioner v. Stone's Estate*, 210 F. 2d 33 (3 Cir. 1954) and Treasury Regulation § 1.421.6.

In this case, Judge Hall found, on the basis of uncontradicted evidence, that the delivery of completion rights and promissory notes was intended by both the taxpayer/partnership/payor and the oil and gas operator/recipient as satisfaction of the fixed obligation to pay a commercially reasonable, arm's-length, bargained for price. That is, the Tax Court predicated deductibility upon the fact that all of the consideration provided for under the lease purchase and turnkey drilling agreement—the cash, the completion option, and the nonrecourse note—had passed to the operator at a closing some time during 1972.

The courts agree that, in the case of an accrual basis taxpayer, intangible drilling costs—the specific item at issue here—are deductible in the year incurred (*Great Western Petroleum Corp. v. Commissioner*, 1 T. C. 624

19. Accruability first appeared on behalf of the Commissioner in a reply brief to taxpayer's alternative argument that deductibility could be based upon § 83 of the Internal Revenue Code.

(1943); *Burdette v. Commissioner*, 34 T. C. M. 610 (1975)) and that all of the conditions for accruability are met when payment is made pursuant to a binding contract between unrelated parties. See, *Miller's Oil and Gas Federal Income Taxation* (1981 edition) at p. 336. Recently, in *Dillingham v. United States*, 48 A. F. T. C. 2d 81-5815 (D. Okla. 1981), the court reached the conclusion that amounts attributable to intangible drilling costs incurred under a fully binding contract were deductible in the year of payment under either the cash or accrual method of accounting.[20]

Since Judge Hall found that there was present payment during 1972 in the instant case, and since it is uncontradicted that the contracts pursuant to which payment was made were not only legally binding but were legally binding upon each party regardless of the other party's counter-performance (the doctrine of independent covenants), the dictum of the court below as to accruability is totally refuted by the facts and is contrary to long-established precedent.

III. Neutral Principles of Law

The court below telegraphed its conclusion, and the true rationale for its conclusion, in the first five words of the Opinion: "In this 'tax shelter' case . . ." (A2) But the buzz words "tax shelter" are merely pejorative in the context of this transaction where the tax purpose is tax deferral (not tax avoidance) and the business purpose is risk shifting.[21]

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20. That court also applied the rule of law as to § 636 announced by the Tax Court here.

21. Nor does it aid reasoned analysis to remark that: ". . . in the meantime the government has provided the investor at least with what is effectively an interest-free loan of the dollars that it otherwise would have taxed away" (A5). *Pari passu*, every

The transactions here in question—and the resulting tax consequences—yield a symmetry:

In the initiation of the transaction:

(1) the (payor) investing partner took deductions based upon the cash and the production payment/note;

(2) the (payee) oil and gas company recognized as income the full amount received (cash plus note).

Upon performance of the contract:

(1) the investor recognized as taxable income,

(a) cash payments on the note arising out of production; and

(b) non-cash income arising out of cancellation of any note; and

(2) the oil and gas companies took matching deductions.

Under the decision of the court below that symmetry is destroyed: the investors' first year deduction (here in tax year 1972) is gone but no relief is offered for the taxes paid on subsequent years' cash and debt cancellation income (1973-1981) to the extent the three-year statute of limitations bars refund claims; the operator recipient of the income has paid its taxes on this income in 1972 but cannot now recoup those tax payments due to the expiry of the three year statute of limitations; and, finally, the operator will lose its deductions for any payments

21. (Cont'd.)
time we pay withholding taxes, or pay a quarterly estimated tax installment, we, ". . . in the meantime [as taxpayers have] provided the [government] at least with what is effectively an interest-free loan of the dollars that it otherwise would [not] have taxed away".

made in any year not remaining open under the statute of limitations. In short, whereas Judge Hall and the Tax Court took into account the carefully structured symmetry of *deduction/income//income/deduction* between the payor partnership and the payee producer in sustaining the tax treatment of the transaction from the investor's standpoint, the First Circuit destroys one or more of the four legs of the symmetry so as to yield: *no deduction/income//income/no deduction.*

In short, under the rules of the court below—given the passage of time and the effect of the applicable statutes of limitation—the Internal Revenue Service now eats its cake (of collecting taxes) and has it, too (of facing severely limited refund claims).

We believe the statute as drafted by Congress (at the urging of the Treasury) must be given the full and fair meaning of the words chosen. A production payment is to be treated as a loan not only when it advantages the Internal Revenue Service to do so (the ABC transaction) but also when it (temporarily) advantages the taxpayers to do so (as in this case).[22]

As the foregoing suggests, the opinion of the court below creates at least as many problems as it purports to solve and is contrary to the intentions of both Congress and the United States Treasury.

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22. *Nota bene:* while the Commissioner won a "victory" in *Crane* by requiring Mrs. Crane to pay about $25,000 in taxes, the "victory" was Pyrrhic from the point of view of the fisc since, considering only the real estate industry, billions of dollars in nonrecourse real estate mortgages have given rise to "tax shelter" depreciation and investment tax credits which have thereby reduced tax receipts. Compare *Tufts*, presently before this Court.

CONCLUSION

For the reasons set forth above, Petitioners respectfully request this Court to issue a Writ of Certiorari to the United States Court of Appeals for the First Circuit and thereby to review the judgment of that court dated September 18, 1982.

Respectfully submitted,

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